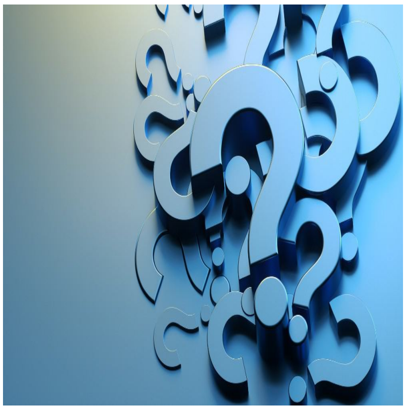

Will Scotiabank (TSX:BNS) Cut its Dividend?

Description

Canadian bank stocks have been under considerable pressure since the WHO declared a coronavirus pandemic in March 2020. First quarter 2020 U.S. bank results indicated that there is a rocky road ahead for Canada's banks. The third-largest lender **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) recently reported its fiscal second-quarter 2020 results.

Better-than-expected earnings

Scotiabank's second-quarter earnings plunged sharply. Net income of $1.3 billion was 41% lower than for the equivalent period in 2019. That can be blamed on the impact of the coronavirus pandemic on Scotiabank's operations and its push to build a cash buffer in anticipation of a sharp uptick in impaired loans and credit losses.

Scotiabank set aside a whopping $1.8 billion in provisions for credit losses, which is a massive 111% year-over-year increase. That was despite credit quality improving during the quarter, as highlighted by the bank's gross impaired loans ratio falling 10 basis points to 0.78%.

Scotiabank, like its U.S. peers, is preparing for a significant downturn in the credit cycle and consequently has taken the opportunity to build massive cash reserves to absorb credit losses.

Despite the sharp decline in the bank's bottom line, Scotiabank stock soared 7% over the last week. This is because Scotiabank's earnings of $1 per share beat the analyst consensus estimate of $0.91 per share.

International banking woes

The worst performing of Scotiabank's operations was its international business, which had become an important growth driver. International banking net income plunged to $185 million, almost a quarter of the $701 million reported a year earlier. This was driven by a combination of weaker revenue with net interest income falling 9% and fee revenue plunging a whopping 20%.

Provisions for credit losses ballooned 62% year over year to just over $1 billion, having a marked impact on international banking's profitability. Scotiabank, despite the division's 0.28% year-over-year reduction in its gross impaired loans ratio to 2.29%, is anticipating a substantial decline in credit quality across its Latin American operations.

Another factor that impacted international banking's performance was a weaker net interest margin. Governments across the region have been reducing official interest rates to stimulate economic growth.

Scotiabank reported a dismal return on equity of 3.5% for international banking, which was almost a quarter of what it had been a year earlier. This indicates that profitability has collapsed and could very well worsen because of the poor economic outlook for Latin America with Scotiabank a top-10 rated bank in Mexico, Colombia, Peru, and Chile.

The region has been hit hard by the coronavirus pandemic, and economies are expected to contract sharply over the coming year. That certainly doesn't bode well for Scotiabank's overall performance when Canada's economic weakness is considered along with the risk of domestic housing crash.

Will the bank cut the dividend?

This raises the question as to whether Scotiabank's dividend is safe. It, like its Big Five peers, has become an important source of income for many Canadians, particularly retirees.

Prior to the latest earnings, Scotiabank's dividend of a very juicy 7% was sustainable with a conservative payout ratio of 52%. The ratio for the second quarter 2020 leapt to a worrying 90%. When it is considered that there is worse to come for Scotiabank, including a further decline in earnings, the ratio could easily exceed 100%.

Nonetheless, Scotiabank possesses the financial resources to sustain the dividend in such circumstances for a short period. That means a dividend cut at this time is not likely, although certainly don't expect another dividend hike.

Foolish takeaway

Scotiabank's latest results were better than expected. Despite the sharp earnings decline, it was able to squirrel away a sizable cash buffer to absorb an anticipated surge in credit losses. While there is worse ahead for Scotiabank, it does appear attractively valued, trading at less than one times book value and nine times projected earnings. The very tasty 7% yield appears safe for the time being.

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